

The Commercial End-User Exemption

CFTC and SEC solicit comments on proposed rules governing the commercial end-user exemption to the clearing requirements of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

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Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act), titled the Wall Street Transparency and Accountability Act of 2010, became law on July 21, 2010. The Act contains significant changes to the ways in which over-the-counter derivatives are regulated. Transactions identified as “swaps” and “security-based swaps” will be regulated under the Act, and those terms are defined broadly enough to encompass most over-the-counter derivatives. Such transactions will be subject to clearing and exchange trading requirements under the Act, and certain parties to those transactions will be subject to capital, margin, registration, reporting, recordkeeping, and business conduct requirements.

Under the Act, the U.S. Commodity Futures Trading Commission (CFTC) is given authority to regulate swaps and the Securities and Exchange Commission (SEC) is given authority to regulate security-based swaps. These regulators have broad authority to promulgate rules implementing the legislation. The two agencies are required to coordinate and harmonize their respective regulation and, in certain cases, to engage in joint rulemaking.

The CFTC and SEC are required to adopt rules under the Act establishing criteria for determining those swaps and security-based swaps that are required to be cleared. Generally, the Act makes it unlawful to enter into a swap or security-based swap that is required to be cleared, unless the swap or security-based swap is submitted for clearing. Recognizing that the reforms contemplated by the Act may result in a hardship to commercial (as opposed to financial) enterprises, Congress included an exemption to the clearing requirements of the Act for commercial enterprises that utilize swaps and security-based swaps. This exemption is commonly known as the “commercial end-user exemption.”

Under the Act, if one party to a swap or security-based swap is not a financial entity (a term that includes swap dealers, security-based swap dealers, major swap participants, major security-based swap participants, commodity pools, certain private funds, ERISA plans, and banking entities), and that party (a commercial end-user) is using the swap or security-based swap to hedge or mitigate commercial risk and notifies the relevant commission how it generally meets its financial obligations associated with noncleared swaps and security-based swaps, then such swap or security-based swap does not have to be cleared. The commercial end-user may, however, still choose to clear the swap or

security-based swap. If the commercial end-user is a public company, an appropriate committee of the board of directors must approve any election not to clear the swap or security-based swap.

The CFTC and SEC have both issued proposed rules that address the requirements of the commercial end-user exemption in greater detail; the comment period for these rules expires on February 22, 2011. The proposed rules (1) define what constitutes hedging or mitigating commercial risk and (2) set forth the manner in which swaps and security-based swaps have to be reported and, in the case of public companies, approved in order to satisfy the requirements of the commercial end-user exemption. Other rules proposed by the CFTC and SEC define the terms “swap dealers,” “security-based swap dealers,” “major swap participants,” and “major security-based swap participants.” Entities satisfying any of these definitions are ineligible to use the commercial end-user exemption.

A detailed analysis is required to determine whether a particular swap or security-based swap would satisfy the requirements of the commercial end-user exemption, and, to the extent a public company desires to utilize the commercial end-user exemption, an appropriate board committee will have to be constituted and related approval procedures will have to be implemented. To learn more, please contact the author of this LawFlash, **Thomas D’Ambrosio** (212.309.6964; tdambrosio@morganlewis.com), or your regular Morgan Lewis contact.

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